



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OCT 15 2002

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

for Joseph G. Kehoe *Joe G. Kehoe*
Commissioner, Small Business/Self-Employed Division

SUBJECT:

Draft Letter Report – The Internal Revenue Service Needs to Simplify Filing Requirements and Clarify Processing Procedures for Small Business Corporation Returns (Audit # 200130037)

I reviewed your draft audit report, which evaluated the effectiveness and efficiency of our policies and procedures established for the filing and processing of small business corporate returns. We generally agree with your report that processing of Forms 1120S (U.S. Income Tax Return for an S Corporation) should be simplified.

Over the years, we recognized the problems associated with the filing and processing of small business corporate returns. We have taken the steps to simplify the process. As a result of our organizational restructuring, only two campuses now file and process these returns.

In addition, we formed a task force to study and resolve the problems identified in your report. The team held their first meeting on September 12, 2002. A second session was held October 2nd and 3rd, 2002. Team members included analysts from Reporting Compliance and from Business Master File (BMF) Policies, Procedures and Guidance Branch, as well as field employees from Reporting Compliance and Submission Processing Centers. The overall scope of the team's efforts included the study of the Form 2553 (Election by Small Business Corporation) election process. The team also studied delinquent elections as well as the process of converting invalid Form 1120S to Forms 1120 (U.S. Corporation Income Tax Return).

We do not agree with the methodology or the reported benefits cited in Appendix IV Outcome Measures. When TIGTA initiated this report, ten campuses filed and processed invalid S-Corporations. Procedures were not consistent among the ten campuses. Therefore, results differed. Currently, only two campuses, Cincinnati and Ogden, process these cases. A Compliance task force is developing standardized procedures that will be issued January 1, 2004. We do not believe you sampled enough cases from the two campuses now processing cases to reliably estimate the

impact of taxpayer burden or potential loss revenue. Additionally, the information from the other eight campuses has significantly skewed the data.

Our comments on the recommendations are:

RECOMMENDATION 1

The Director, Compliance, SB/SE Division, should simplify the process of filing election forms and Forms 1120S for new filers by determining if there are alternatives to make it easier for first-time filers to be granted elections and file their Forms 1120S, and by considering implementing alternatives and seeking modification of the legal requirements, as necessary.

RECOMMENDATION 2

The Directors of Customer Account Services and Compliance, SB/SE Division, should develop procedures that would improve and simplify the process for approving, recording, and controlling elections and the related notification process to make it easier for taxpayers to file their Forms 1120S.

ASSESSMENT OF CAUSE

We have not developed clear and consistent guidelines for processing the Form 1120S when delinquent elections are received. Taxpayers are subject to inconsistent treatment when invalid 1120S returns are converted to Form 1120.

CORRECTIVE ACTION

Reporting Compliance has formed a task force to study and resolve the causes identified above. The team held their first meeting on September 12, 2002. A second session was held on October 2nd and 3rd, 2002. Team members included analysts from Reporting Compliance and from Business Master File (BMF) Policies, Procedures and Guidance Branch, as well as field employees from Reporting Compliance and Submission Processing Centers.

The overall scope of the team's efforts included the study of the Form 2553 election process, including delinquent elections, as well as the process for converting invalid Forms 1120S to Forms 1120.

IMPLEMENTATION DATE

January 1, 2004

RESPONSIBLE OFFICIAL

Director, Reporting Compliance
Director, Customer Account Services

CORRECTIVE MONITORING PLAN

The Program Manager, Service Center Compliance Policy and branch manager of BMF Policies, Procedures & Guidance will provide regular status updates to the Director, Reporting Compliance.

RECOMMENDATION 3

The Director, Compliance, SB/SE Division, should establish procedures for ensuring that IRS records accurately reflect the filing of Forms 1120S once the IRS subsequently verifies that an election was granted. Specific procedures should be developed for converting the Forms 1120 back to the originally intended Forms 1120S.

ASSESSMENT OF CAUSE

Once we process a return to the taxpayer's account, it establishes a fact of filing and begins running the statute of limitations. The document locator number (DLN) is an administrative record, which indicates how our computer systems processed the return and provides a reference for retrieving the document. If the account is subsequently adjusted, that DLN changes and the return loses its initial character.

CORRECTIVE ACTION

We do not see a need to make a correction to indicate that the original filing was a Form 1120S. By correcting the records to indicate that a valid election existed for that period, we have essentially established that the filing requirement was met. The actual document is the record of the taxpayer's intent. However, the task force (see Recommendations 1 and 2) will look at this issue further to determine if any alternatives exist.

IMPLEMENTATION DATE

January 1, 2004

RESPONSIBLE OFFICIAL

Director, Reporting Compliance

CORRECTIVE MONITORING PLAN

The Program Manager, Service Center Compliance Policy will provide regular status updates to the Director, Reporting Compliance.

RECOMMENDATION 4

Clarify the Internal Revenue Manual procedures and assign responsibility for determining and assessing the correct taxes and issuing statutory notices of deficiency for small business corporate returns that could not be processed because the IRS could not verify that valid elections were filed.

ASSESSMENT OF CAUSE

Current IRM procedures do not clearly explain how these cases should be processed.

CORRECTIVE ACTION

The team will work with Chief Counsel to determine the proper way to assess taxes on small business corporate returns that we could not process. After we resolve this issue, we will update the appropriate Internal Revenue Manual procedures.

IMPLEMENTATION DATE

January 1, 2004

RESPONSIBLE OFFICIAL

Director, Reporting Compliance

CORRECTIVE MONITORING PLAN

The Program Manager, Service Center Compliance Policy will provide regular status updates to the Director, Reporting Compliance.

If you have any questions, please call Joseph Brimacombe Deputy Director Compliance Policy, Small Business/Self-Employed Division, me at (202) 622-0600 at (202) 283-2200.

